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C O N F I D E N T I A L SECTION 01 OF 03 LUSAKA 000339

SIPDIS

E.O. 12958: DECL: 05/17/2019
TAGS: ECON ZA
SUBJECT: ZAMBIA BURDENED BUT NOT OVERWHELMED BY IMPACT OF GLOBAL ECONOMIC CRISIS

REF: A. LUSAKA 322
¶B. LUSAKA 295
¶C. LUSAKA 31

LUSAKA 00000339 001.2 OF 003

Classified By: Ambassador Donald Booth for Reasons 1.4(b) and (d).

¶1. (SBU) Summary. Although its financial sector is largely unscathed by the global economic crisis, Zambia's prospects for growth are diminishing due to decreased foreign investment, layoffs in the mining sector, and rising unemployment. Lower (from brief, speculation-driven highs in mid-2008) world copper prices mean decreased mining sector profitability, lower mining tax revenues, and limited fiscal space for the Zambian Government (GRZ) to implement its new economic diversification strategy. Through relatively sound fiscal and monetary policy, the government has been able to steady its macroeconomic indicators -- at 15 percent, the inflation rate is high but not climbing, the Zambian Kwacha has depreciated by 50 percent (from a two-year high in mid-2008) but is now stable, and foreign currency reserves are diminishing but are being replenished through IMF loans and perhaps expanded Special Drawing Rights. Many Zambian critics have heaped the blame for Zambia's economic hardships on President Banda, who came into office in October 2008, just as the crisis began to be felt in Zambia. This has weakened the President's already fragile support base. End Summary.

Impact of Crisis

¶2. (SBU) The global economic downturn's impact on the demand for and price of copper is where Zambia's commodity-driven economy (Ref C) is feeling the most pressure. Although some mining companies increased their copper production in 2008, the mining sector's overall profitability decreased due to lower world metals prices. In the past six months, most mining companies suspended new projects or consolidated/streamlined existing ones to cut costs in the face of scarce credit and unprofitable commodity prices. Some shut down operations completely for short periods, and a larger number of mine service companies have been forced out of business. According to recent GRZ estimates, the mines have shed two to four thousand jobs, resulting in sector-related job losses exceeding ten thousand.

¶3. (C) Zambia's tourism sector has also been hit by the economic crisis. According to the Livingstone Tourism Association, hotels and lodges near Victoria Falls (Zambia's premier tourist attraction) have seen a 50 percent drop in bookings this year, resulting in some downsizing in the sector. Tourism associations are unaware of the actual number of job losses that the sector as a whole has

sustained, but appear to be more concerned about lack of investment and sectoral growth than in actual unemployment. According to the World Travel and Tourism Council, employment in Zambia's tourism sector will "level off" at 72,000 employees this year. A well intentioned but misplaced tourism policy (Ref A) will do little toward helping the government support the tourism sector, let alone to attracting foreign investors and tourists.

¶4. (U) These factors, combined with declining levels of foreign direct and portfolio investment in 2008 contributed to the depreciation of the Kwacha, which slid from a 2008 high of 3,500 Kwacha per USD to its current rate of 5,200 per USD. Zambia's weak Kwacha will exert additional pressure on the inflation rate, making it difficult for the GRZ to return to single-digit inflation from its current (year-on-year) level of 15 percent. To hedge against currency volatility, many vendors have begun pricing their goods in USD. Although mining tax revenues constituted only five percent of government revenue in 2008 (due to the extremely favorable tax conditions granted to the mining companies during privatization), reduced tax receipts nevertheless will have an impact on government spending. Perhaps more significantly, reduced mining revenues, which account for eight percent of GDP and over 70 percent of Zambia's export earnings, are likely to worsen Zambia's current account and trade deficits.

¶5. (U) Following almost a decade of real gross domestic product (GDP) growth in excess of five percent, the Economist Intelligence Unit predicts the Zambian economy will contract by about one percent in 2009. International Monetary Fund (IMF) analysts are less pessimistic, putting growth at between two to three percent. Given rebounding copper prices and projections for a good harvest year, IMF estimates may be

more reliable. Zambia's GDP/capita will continue to be constrained by its high birth rate (at 40.2 births/1,000 population) and declining death rate (at 21.4 deaths/1,000 population due to PEPFAR and other foreign aid to the health sector). Ultimately, the crisis means that fewer Zambians will be supporting larger families with less money (due to inflation and the depreciating Kwacha). Experts estimate that each Zambian worker typically supports an average of ten family members; mining layoffs are therefore likely to result in food insecurity to over one hundred thousand Zambians. The global economic crisis, within the context of higher global food and commodity prices (corn meal prices have increased over 55 percent in the past year) places tremendous pressure on the government to mitigate the social impacts of this economic insecurity.

GRZ Response

¶6. (C) On occasion, the GRZ has responded positively to this pressure. President Banda is evaluating ways to improve the GRZ's inefficient fertilizer support program, the GRZ has cancelled its potentially onerous mining windfall tax, and Cabinet members have expressed openness to removing bans on biotechnology. The GRZ has also shown some commitment to expediting its capital expenditure spending procedures, which in the past have been slow and unwieldy and the cause for failing to spend large portions of the GRZ annual budget as allocated. In general, however, the GRZ has moved slowly and timidly to mitigate the effects of the crisis. For example, following the closure of Luanshya Copper Mine (LCM), the GRZ pursued new investors ham-handedly and with no transparency, finally awarding the concession to a Chinese company five months after LCM's closure. Additionally, the absence of a Transport and Communications Minister (who resigned after a tribunal showed that she had circumvented government tender procedures) and the lack of an independent procurement authority (Ref B) are likely to limit the GRZ's ability to

carry out its rural infrastructure development program that is key to promoting agricultural expansion and economic diversification.

¶7. (C) The Bank of Zambia has been the GRZ's saving grace thus far, conducting a monetary policy that has steadied inflation and cushioned Kwacha volatility. Although the Finance Ministry has shown signs of fiscal prudence, recent decisions to borrow for extravagant and extraneous purchases (e.g. a proposed no-bid USD 53 million contract to a Chinese company for nine mobile hospitals in a deal so controversial that the Chinese Embassy had to publicly claim it had no involvement in it) at the expense of basic needs like school classrooms and hospital beds, has cast a shadow on the current government's sense of judgment and accountability (the GRZ eventually stepped back from the mobile hospital deal under pressure from donors). At the same time, GRZ funding to the Anti-Corruption Commission and Task Force on Corruption almost has slowed to a halt, fueling speculation among civil society organizations and the independent media that the GRZ is not only turning a blind eye to corruption, but actually participating in it. According to the Jesuit Center for Theological Reflection, a prominent local non-profit organization, representatives from the Auditor General's office as well as the Parliamentary Public Accounts Committee are alarmed about government's indifference to recent findings of misappropriation and theft.

Signs of Recovery

¶8. (SBU) Despite the albatross of corruption, there are indications that Zambia's economy may be improving. A broker on the Lusaka Stock Exchange (LuSE) told emboff that foreign portfolio investment on the LuSE is beginning to see an upswing, including renewed interest from U.S. fund managers. She projected that the Kwacha would slowly strengthen in response to rising copper prices. Despite this development, recovering investor confidence may not translate to pre-crisis levels of foreign direct investment or result in increased foreign participation in Zambia's bond market. An April treasury bond tender was under-subscribed by over 50 percent, marking a significant change from one year earlier when treasury bond tenders were over-subscribed by over 200 percent (for two-year bonds). Investors almost entirely ignored a February Treasury tender on 15-year bonds, suggesting lack of investor long-term confidence, particularly in the absence of a formal secondary bond market that would increase asset liquidity.

¶9. (C) A corporate banking representative also expressed his positive outlook to emboff, noting that he is beginning to see some signs of economic recovery, due in part to rebounding copper prices (now at USD 2/lb, up from about USD 1.20/lb in January). He acknowledged the increased likelihood that his clients will default on loans but projected optimism about the private sector's resiliency. He predicted that scaling back by some mining companies would be offset by production increases among others. Indeed, the Chinese economic counselor told emboff that his government is viewing the current downturn with a long-term perspective and encouraging Chinese companies to maintain their presense in Zambia and to avoid firing employees or delaying investments. At least one Chinese company is abiding by this advice and its announcement to move forward on existing mining projects has curried much favor with the GRZ.

¶10. (SBU) In general, the global economic downturn has had a modest effect on Zambia's financial sector, due to its limited integration with global financial markets, its relatively high liquidity, and its risk-averse lending practices. Interest rates on USD loans are high (ten to twenty percent) and Kwacha loans are even higher (twenty to

thirty percent). Neither is likely to become more competitive until inflation rates (about fifteen percent and heavily pressured by the weak Kwacha) subside. Zambians are more prone to complain about the availability than the cost of capital. Limited access to financing will continue to constrain private sector led growth as well as agricultural investment, but not much more so than before the global financial crunch. Most importantly, credit lines will continue to be available to existing clients so that the operations of already profitable companies will not be constrained by liquidity shortages as in other financial markets.

Comment

¶11. (C) In addition to these economic impacts of the global economic crisis, there may be political implications to Banda's government. Opposition leaders have been quick to blame Banda for the country's economic turmoil and their arguments seem to be resonating with much of the Zambian public. If the economy experiences little improvement before the 2011 presidential election, Banda may fail to secure his party's nomination and/or the party could see an end to its 20-year rule. During Foreign Minister Pande's upcoming visit to Washington, we should reiterate that progress on corruption is critical to Zambia's continued eligibility for Millennium Challenge Account compact funding, a potentially critical resource to support poverty-reducing investments in Zambia's economic growth.

¶12. (C) We should also underscore that there is much that the GRZ can do to improve the country's economic prospects, particularly by accelerating policy reforms that will stimulate domestic investment, open export markets, and promote entrepreneurship. The GRZ deserves some praise for resisting pressure to intervene to strengthen its Kwacha. With a little encouragement, it might more actively seek ways to promote exports (agricultural products in particular) that its weakened currency has made more competitive. Additionally, by expediting the movement of goods at its ports of entry, the GRZ could bring down transportation costs, thereby making imports more affordable to domestic consumers despite the Kwacha's depreciation.
BOOTH